RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Feb. 10 DJIA 1160.70; PTI 1747; A-D Ratio -17.90
Feb. 17 DJIA 1148.87; PTI 1727; A-D Ratio -18.29

CORRECTIONS, BEAR MARKETS: From the investor's standpoint, what's the difference between a major correction and a bear market? One answer is in our strategy. If a primary bull market goes into a corrective phase, then one has his choice of riding out the correction and adding more stock as the correction nears its end. Or one can attempt to sell out near the top and reinstate his position near the bottom.

From the businessman's point of view, a bull market correction may usher in a slide in business or even a recession. The businessman is entitled to remain conservative yet optimistic during a bull market correction. He should probably even plan for expansion or more aggressive tactics as the correction nears its exhaustion point.

What about a bear market? Ah, that's a horse of an entirely different color. A primary bear market (like a primary bull market) is a law unto itself. Nobody can know what lies ahead when the bear holds the stock market and the economy in its grip. And nobody knows during a bear market how far or how long the downward ride is fated to carry.

A very simple way of viewing the two phenomena is as follows: a bull market correction tends to halt speculation in stocks and it tends to teach businessmen that the economy (like Wall Street) is a two-way street. In other wrods, a correction does just what it implies—it corrects.

But a primary bear market *wrecks.* It squeezes the water out of stocks, and if a given company can't take the squeeze, then that company goes belly-up. A bear market sends the economy reeling and it tests every business' ability to SURVIVE. Robert Rhea used to say that just as a bull market can be likened to the light of day, a bear market is its opposite—night. Some people operate at night and some people even have fun at night. But for the average person, navigating during the black of the night is a scary proposition. They are very apt to trip and fall.

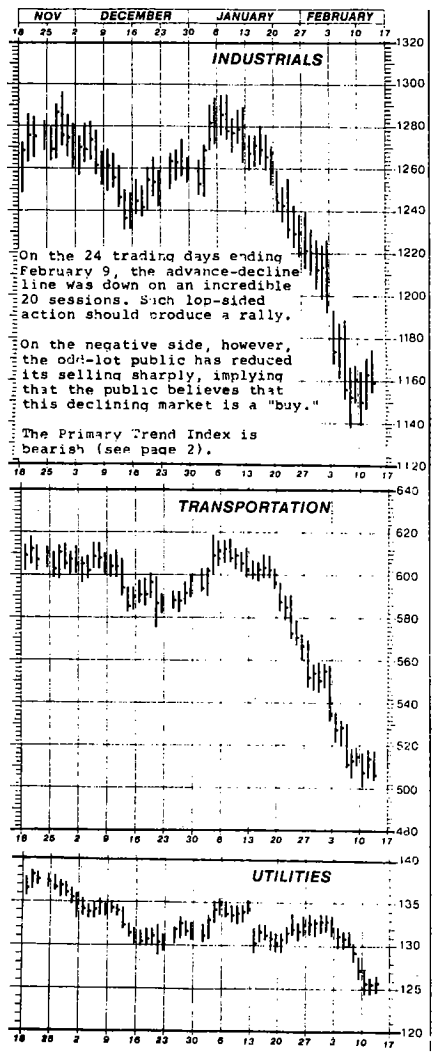
How do we differentiate between a bull market correction and a primary bear market? It's not always easy, particularly during the early stages.

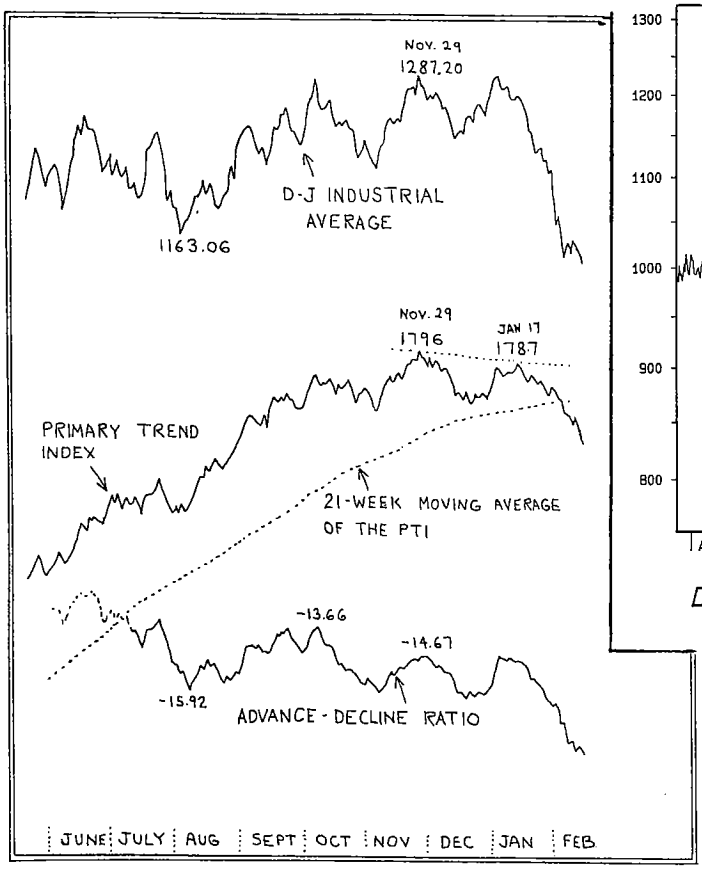
In the last Letter I described the classical bear market signal. Here's how it works. The Averages go into a decline, and the decline may take a few weeks to a few months. In recent years the average secondary reaction has tended to correct one-third or less of the previous major advance.

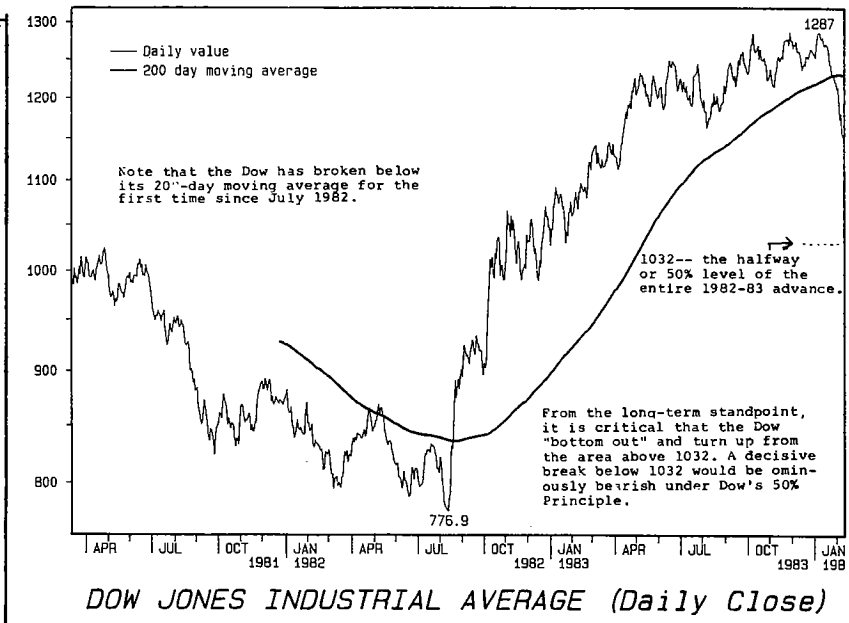
It is what happens AFTER the initial decline that is crucially important. Following the reaction low there will be an advance of a few weeks or more. The advance will test the ability of the Averages to come back towards the highs. If the advance takes the averages back over the highs then obviously the green light is on and all is well. But if one or both Averages (Industrials and Transports) fail to better the old highs, and they both turn down again, it is then that the investor holds his breath. For if the two Averages then break the previous secondary lows a bear market is signalled. We then go back and re-classify the initial "reaction" as the first leg of a new primary bear market.

But the stock market doesn't make anything easy. In recent years the market has tended to make straight-line moves, without giving us classic bull and bear signals. Why this is so I am not sure, but I suspect it is a product of mass communication. Business news is the hottest game around today, and everyone wants to know what everybody else is doing—and instantly. So when the market starts up (or down) the moves are likely to gather a progressively larger following with no correction or major pause. Then the move goes to exhaustion and classification along the way is rendered very difficult.

I have attempted to deal with the "straight line" phenomenon in a few ways. One is via my Primary Trend Index. The PTI has had a history of being very good on tracking the primary trend. It has not produced many whipsaw moves, and it has tended to follow extended trendlines. For this reason I have told my subscribers that I want always to be on the "right side" of my PTI. This means that when the PTI is in a rising trend, I want to be in stocks. When the PTI is in a falling trend I want to be out of the market. I classify the PTIs direction on the basis of (1) rising tops and bottoms (bullish) and


NOV
DECEMBER
JANUARY
FEBRUARY
INDUSTRIALS
On the 24 trading days ending February 9, the advance-decline line was down on an incredible 20 sessions. Such lop-sided action should produce a rally.
On the negative side, however, the odd-lot public has reduced its selling sharply, implying that the public believes that this declining market is a "buy."
The Primary Trend Index is bearish (see page 2).
TRANSPORTATION
UTILITIES




Daily value
200 day moving average
1287
Note that the Dow has broken below its 20-day moving average for the first time since July 1982.
1032-- the halfway or 50% level of the entire 1982-83 advance.
From the long-term standpoint, it is critical that the Dow "bottom out" and turn up from the area above 1032. A decisive break below 1032 would be ominously bearish under Dow's 50% Principle.
776.9
1300
1200
1100
1000
900
800
APR JUL OCT JAN APR JUL OCT JAN APR JUL OCT JAN
1981 1982 1982 1983 1983 198

DOW JONES INDUSTRIAL AVERAGE (Daily Close)

(2) declining tops and bottoms (bearish). To render the reading of the PTI even more mechanical, I say that when the PTI is above its 21-week moving average it is bullish; when the PTI is below its 21-week moving average it is bearish.

There is another way of checking on the primary or major trend of the market. It is a method that was used extensively by E. George Schaefer, the great Dow Theorist of the 1940s through the early 1970s. Schaefer made extensive use of what he termed Dow's 50% Principle. On December 6, 1952 Schaefer wrote, "Years ago, while studying the work of William P. Hamilton as edited in the Wall Street Journal, I made an attempt to discover some of the secrets of Hamilton's success. . . . . After many years of careful study. . . . . I reached the conclusion that one of his trade secrets was Dow's 50% Principle. Some eighteen months of carefully checking back what was said and what the market did was required before this method of analysis finally began to unfold itself."

What Schaefer uncovered was this. Following an EXTENDED rise what the market does on the subsequent correction is critical. Note that I use the phrase extended rise. The 50% Principle is unsatisfactory in dealing with minor or even secondary movements and it only should be used in relation to a market average rather than with individual stocks.

Following the extended rise (such as the 1982-83 rise), what the market (in this case I am using the Dow) does on the inevitable correction must be watched carefully. If the Dow succeeds in retaining 50% or more of the ground gained on the preceding major rise, the Dow and most stocks (in due time) should approach or even better the old highs.

On the other hand, if the decline following a major and extended rise takes the Dow below the 50% level of the preceding rise, then the 50% Principle will turn bearish. In that case, the Dow and most stocks will probe the base from which the entire rise began.

Again I stress that the 50% Principle does not work well for individual stocks nor does it work well in gauging limited movements. It works best in gauging *major movements* such as the rise in the Dow from 766.92 (August 1982) to 1287.20 (November 1983). The halfway level of this great rise comes in at 1032.06. Therefore, the 1032 level now assumes MAJOR IMPORTANCE!

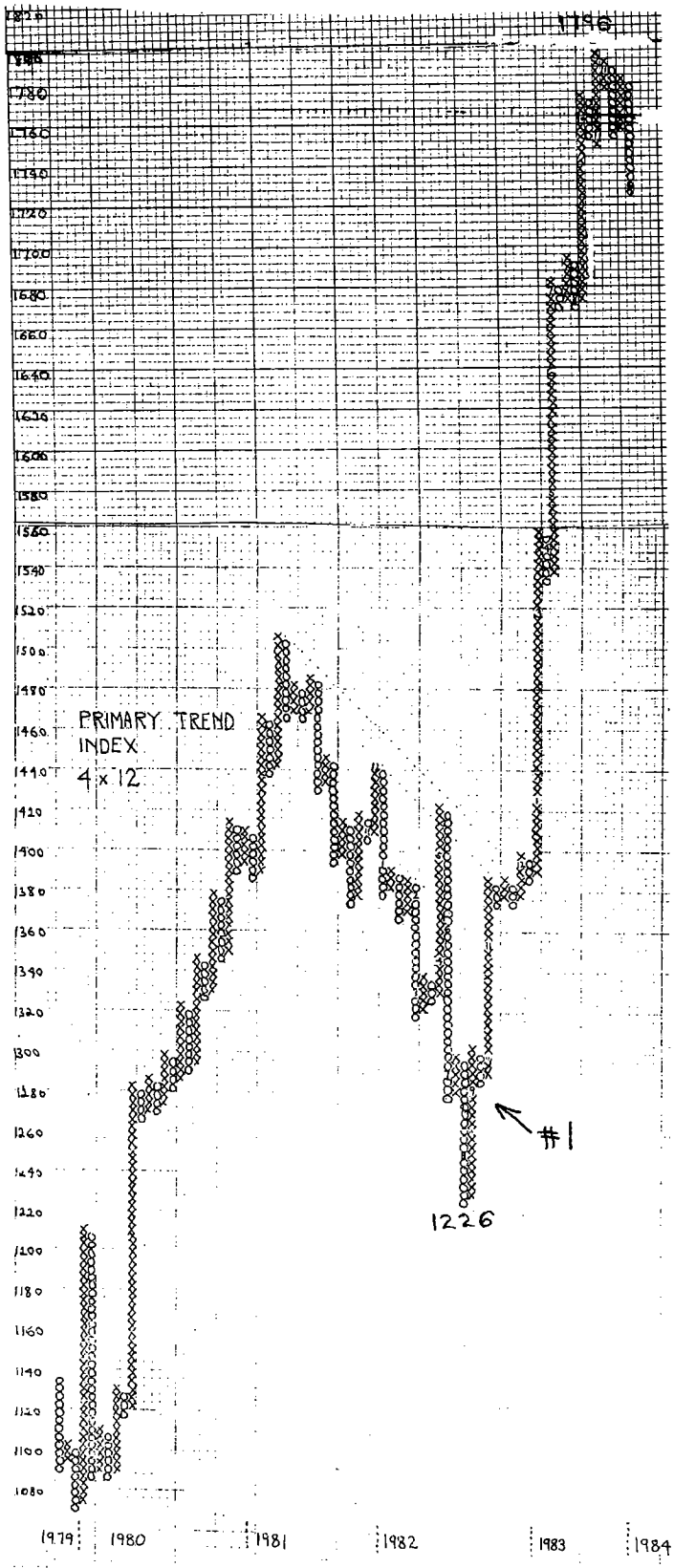
If, following whatever declining action lies ahead, the Dow can hold above that 1032 level, we will have a very hopeful indication under the 50% Principle. In fact, the LONGER the Dow holds above 1032 the more hopeful the situation. Ideally, we could see the market start to base with the Dow still this side of 1032. Then, if the Averages break out of that base and head higher, we will have the most optimistic picture possible under Dow's 50% Principle.

PRIMARY TREND INDEX: My PTI broke below its "head-and-shoulders" support line on February 6. At the same time, the PTI violated its 21-week moving average. On any reading of the PTI, this means that the PTI has reversed from bull to bear. So despite all my hopes, and despite the record high short interest and short interest ratio statistics, I was forced to turn bearish on the market.

I keep a number of different charts on the PTI, and one of the most interesting (and significant) at this time is my 4 x 12 point and figure chart. Each box on this chart is equal to 4 points on the PTI, and only reversals of 12 points or more are entered. In this way the chart concentrated a lot of movement (five years in this case) onto a single page.

Note the head-and-shoulders *base* (no. 1) that was formed during 1982. This strong base was the platform for the most explosive rise in the 13 year history of the PTI, a rise from 1226 in August 1982 to 1796 in November 1983.

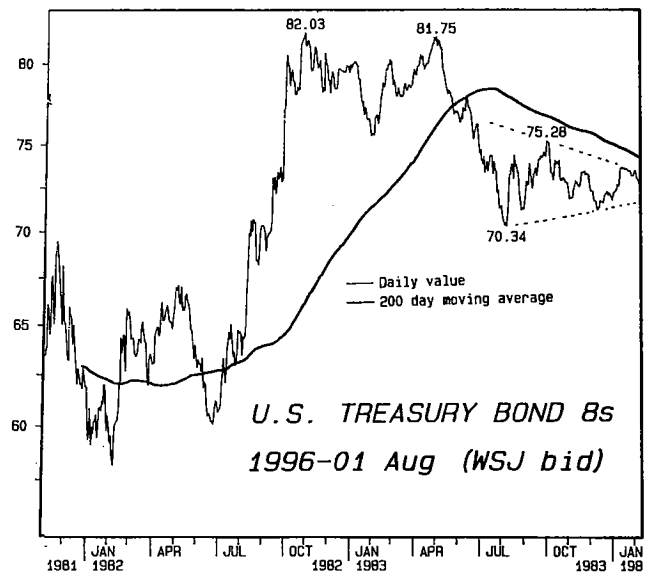
Note that following the 1982 base, the PTI rose in a series of four steps, with a cluster or consolidation at the end of each step. The 1983 cluster was the largest of the four, and I felt that



this might be a platform for still another rise. That was not to be. On February 10 the PTI gave a point & figure sell signal when it dropped to the 1748 box, thereby sinking below the preceding decline low.

One of the valuable things about the point & figure method is that it provides "counts" or projections when a support or resistance level is violated. Based on the recent bearish signal, the point & figure count for the PTI now measures to a target of 1668. In order for such a drop to materialize, the PTI will have to sink to the last congestion zone in the 1660-1680 area on the chart. After that we will see what the PTI pattern looks like. I might add that so far, P & F projections for the PTI have worked out remarkably well.

In primary bull markets, P & F advances tend to overrun the projections or count. Conversely, in primary bear markets the PTI tends to overrun the downside projections. Therefore, it will be instructive and valuable to see if the 1668 count is met or surpassed as we move on in 1984. If the PTI never fulfills its 1668 count, that will be a very hopeful sign. If the PTI goes well past 1668 on the downside (if it breaks below the last cluster), that will be a very bearish sign and will probably mean that we are facing a full correction of the entire PTI spike from 1226 to 1796. Such a correction would almost surely mean a primary bear market on Wall Street.



BONDS, MONEY: Subscriber and computer expert John Carder ran this chart off for me. Here we see the Treasury 8s hitting a low in July (having broken below their 200-day moving average), and then forming a triangle pattern. Despite almost non-stop news of record deficits, the T-bonds are not doing badly. Most of the money market gurus have forecast higher interest rates and lower bonds for 1984. If the Treasury 8s of 1996-01 break 70, I'll believe it. So far, they are holding stubbornly above 72.

INVESTMENT POSITION: I can't prove it's a primary bear market at this time, but I have taken the bull out of the box. From an investment standpoint, the Dow is under its 200-day moving average, all the major averages have broken below their December lows (definitely not a good omen), and the PTI has fallen out of a head-and-shoulders top and then below its 21-week moving average. The best place to be now is in a money market fund or in T-bills and notes. The direction of the bond market is unclear. At just a fraction under a 12% yield, the longer-term Treasury bonds are almost irresistable–but they could get even more irresistable as time goes on.

Are stocks better than bonds here? Ponder this: the total annual return (appreciation plus dividends) on the Standard & Poor's broad 500 Stock Index for the last 10 years was 10.50%. But the current yield on the super-safe long-term US Treasury bonds is now 12%. Ah, that's the problem, and it will only be solved in one way. Interest rates would have to go down. And that's

why today's huge budget deficits are so feared by Wall Street. The problem of bonds vs. stocks was never clear.

WHAT I LEARNED: In December and January Letters I stressed the extraordinarily high short interest ratios on the NYSE. Two weeks ago a gentleman called from a large brokerage house. The man was a senior vice-president. He told me that he was short over one million shares of stocks but was "long the market." The way this works, he said, is that I loan the short shares, and I get interest on the loan. With that interest I bought calls on various stocks. "Thus, while I am short over a million shares, I am actually long the market. And dozens of other traders have done the same thing. Therefore, I say that the short interest figures are now very suspect."

All of which makes me wonder whether we can really trust the short interest figures any longer. With option trading rampant, with hedging via options and short sales commonplace, it does seem to me that we have to rely more than ever on the ACTION of the market rather than the various sentiment figures.

The fact is that the state of market sentiment and psychology is open to opinion, subjective interpretation, mistakes due to various arbitrage techniques. But price action is price action. When General Motors is 75 there are no ands, ifs, or buts about it. That is the price. When the Dow is 1100 that's a price level, and there is no adjustment or re-interpretation needed. I am more sold than ever on interpreting the market on the basis of prices and price action.

I remember that William P. Hamilton, brilliant second editor of the Wall Street Journal wrote in 1927, "What we need are soulless barometers, price indexes and averages to tell us where we are going and what we may expect. The best, because the most remorseless of these barometers, is the recorded average of prices in the stock exchanges." No truer words were ever written about the stock market.

Along these lines, I am pleased that when I first formulated my Primary Trend Index, I made sure that all eight components of the PTI were based on price action alone without the addition of any market sentiment indicators.

ON HOLD: President Reagan ran on a "cut the Government expenses" and "Let's balance the budget" platform. But somewhere along the line, the President threw in the towel. Older subscribers remember that when Jimmy Carter was elected, I stated that the FIRST ORDER of business was for Carter to do whatever he had to—to balance the Federal budget. Nothing was done, and the deficits continued.

I wrote Letter after Letter showing how the debts and deficits were acting "like compound interest in reverse." They were burying the country in a sea of red ink. Then when Reagan was elected I said, "This is his chance. The President's first task should be to "take it to the people," to make massive cuts in the entitlements programs and balance the budget. But Reagan never took a strong stand. He "spanked" Budget Director Stockman when the latter disagreed with him, and he let the deficits run again. By the second year of his office, the golden chance was gone. Taxes were cut, and deficits washed over the Nation like a tidal wave.

Now the Reagan honeymoon is over. And Reagan has opted for the political solution. Let's get by the 1984 elections, he says, and then we'll attack the deficits. In the meantime, the President is trying to put the economy "on hold."

I've been writing about debts and deficits so long that I finally grew tired of writing about them. Meanwhile, the solution continued to deteriorate. Last month I presented my plan for eliminating the deficits with a 5% national sales tax with all proceeds mandatorially going towards eliminating the deficit. I was hoping that some subscriber close to the President might convince him to act before it was too late. I don't think in the 25 years that I've been writing these reports that I ever tried to influence politicians in this way. I tried.

What is happening in Federal Finances today is no laughing matter, and it could easily end up as a great tragedy. Here's a scenario I've thought about. I'm not saying that it will happen—but it could.

Wall Street experiences a major bear market as the Dow breaks the halfway level of its entire rise, smashing through the 1032 level. Business, taking its cue from Wall Street, pulls in its horns. The public (and there are a record 42 million owners in the stock market today) turns frightened and conservative, following their 1983 buying spree. They decide to retreat to the storm shelters. Business sinks towards recession, and corporate profits slide. Tax receipts to the US Treasury fall far short of expectations, and the budget deficit for 1984-85 looks more like 250 billion than the expected $180 billion. Forecasters start talking about a $300 billion deficit in 1985-86.

In the face of a massively expanded need for financing on the part of the Treasury, the bond market heads south with a vengeance. Rates on the long T-bonds rise to 13½%. Today's 3-4% inflation turns to net deflation. With 13½% bond yields and a deflation rate of 2%, the real return on the bonds rises to 15½%. A mass exodus from stocks to bonds ensues. Well, you can take it from there. But it is not a "far-out" or crazy scenario. It could happen, and it would be the recipe for a primary bear market.

But it may be too late. Let's face it, the Democrats may be patriots, but they are politicians first. And I have my doubts about whether they want to give the President a helping hand in an election year. After all, with the Marines now on ships off Lebanon, what issue do the Democrats have against "the Great Communicator" except the deficits and an out-of-control budget?

NOTES & QUOTES: I can tell you that there are a number of conservative newspaper columnists who are not happy about the way things are going in the Reagan reign. Here's a piece of a Patrick J. Buchanan column dated February 13.

> **As the Soviet missiles were withdrawn from Cuba, in resolution of the 1962 crisis, Charles De Gaulle observed, "There is only *one* superpower." Observing the Marine retreat from Beirut under the covering fire of the Sixth Fleet, he might make the same observation.**
>
> **If it remains the defining characteristic of a superpower that, once its prestige and military are committed, it prevails, the United States no longer belongs in the category.**

And here's George F. Will, who (to say the least) is not enamoured with the Reagan budget.

> **Supporters of the Reagan budget (one can barely use the plural: The supporters are Reagan and Regan) have elevated Micawberism to fiscal policy: Something will turn up. Or: Bold things will be done in 1985, when the election is over. But the 1986 election will not be over. We are never more than two years away from an election involving 468 (435 representatives, 33 senators) of the 537 persons sent to Washington by elections.**
>
> **Reagan's budget may shatter three Reagan achievements — the defense buildup, low inflation and the revitalized Republican Party. Congress will use the deficits as an excuse for doing what every fiber of its being cries out to do — retreat from defense spending. The deficits cannot be financed without inflation.**
>
> **Republican strength is related to the belief that the party may not be nice but is sensible — that it is hardhearted but also hardheaded. The new budget is the Republicans' "Chapter 11," a declaration of bankruptcy of political will and intellectual integrity.**

* *

California is probably going to be the 33rd state to ratify a measure calling for a Constitutional amendment to force Congress to balance the budget. If 34 states pass such a measure, Congress (by Constitutional law) will be forced to call the first Constitutional convention since Alexander Hamilton called the Constitution's authors to Philadelphia in 1787. We're getting close, very close, to an explosive but little appreciated situation.

IDEAL: It's strange but in the 25 years that I've been writing these reports one piece that I wrote in September 1977 has been requested more than any other. The piece does not have to do with the stock market, it has to do with the ideal business. I guess I have an awful lot of subscribers who are either corporate executives, in their own business or who want to start their own business. Anyway, last week I received three requests again for the 1977 column. I have never before re-published a piece that I have written, but here is the article on the ideal business.

IDEAL: There's no such thing as a "perfect Democracy," and there probably never will be. But political experts can describe what the perfect Democracy would be like. Therefore, you can rate any supposed Democracy on how close it comes to the ideal.

By the same token, there never was a perfect business, and there never will be. But let us assume that any business exists to produce profits (of course a business can do a thousand other things, but if it is to exist, it must produce profits). I have long pondered on the various factors which might combine to produce the perfect business. I have been in a number of businesses myself (everything from textile designing to book publishing to owning a night club on the side), and I have talked to hundreds of successful businessmen (and some less than successful). During all those years, I have always wanted to get a list of "ideal factors" together.

The following is my list (at least, up to this point). You might gauge your own business or profession on the basis of this list, or you may want to use this list as a reference for measuring the potential for a new enterprise.

(1) The ideal business sells the *world*, rather than a single neighborhood or a single city or locality (in other words, it has a huge market).
(2) The ideal business has a product with "inelastic demand." This means that people *need it*, almost regardless of price.
(3) The ideal business has low labor requirements; the fewer people needed, the better.
(4) The ideal business sells a product which fits a *continuing* human (or animal) *need*. It's not a fad product, it's not a product which people can easily substitute or even do without.

(5) The ideal business has low overhead; it does not need an expensive location, it does not need large amounts of electricity, advertising, legal advice, etc.
(6) The ideal business produces a product which is difficult (or almost impossible) for a competitor to copy or reproduce. This means the product is an original (such as a publication) or it requires very special knowhow, or it produces a product which is *protected* by copyright or patent.
(7) The ideal business does not require huge cash expenditures or large investments in equipment. In other words, it does not tie up your money.
(8) The ideal business is a business that has cash billings; it does not tie up your money in extended credit arrangements.
(9) The ideal business is relatively free from all kinds of government and industry regulations.
(10) The ideal business is portable. You can put it anywhere you want, in Florida, California, the Canary Islands.
(11) Here's a crucial but overlooked one: the ideal business is one that keeps your full intellectual (and often your emotional) energies.

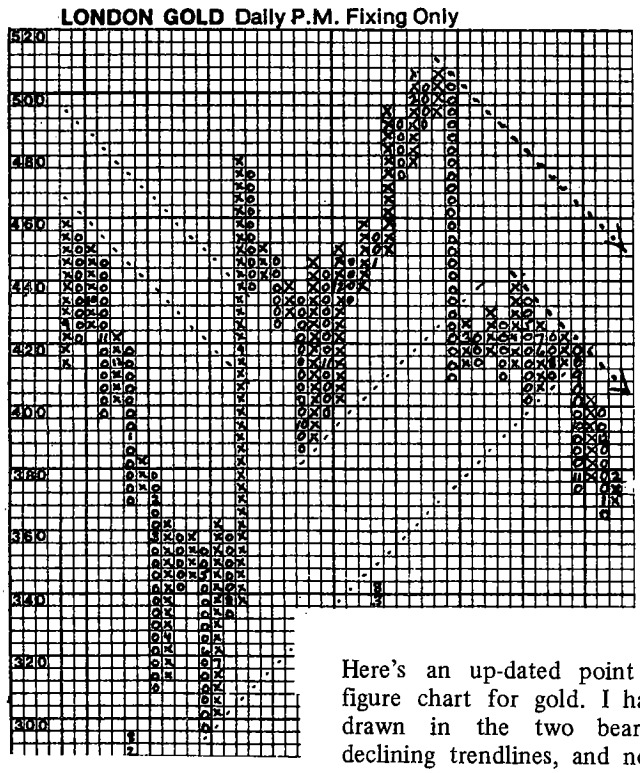
There you are. If you use this list, it might help you cut through a lot of nonsense and hypocrisy about what you are doing and what you are looking for. None of us owns or works for an ideal business. But it's nice to know what one would look like.

GOLD: Gold has some technical plusses going for it now. My gold-to-common stocks ratio has switched rather decisively in favor of gold. This is a relative strength indicator, so that it does not guarantee that gold will rise. It simply says that gold is now outperforming common stocks on a longer-term relative strength basis. Thus, both gold and common stocks could go down, but gold would go down LESS than common stocks. Nevertheless, almost every major gold rise has occurred with this indicator in favor of gold (as it now is). Consequently, the test for gold is now on.

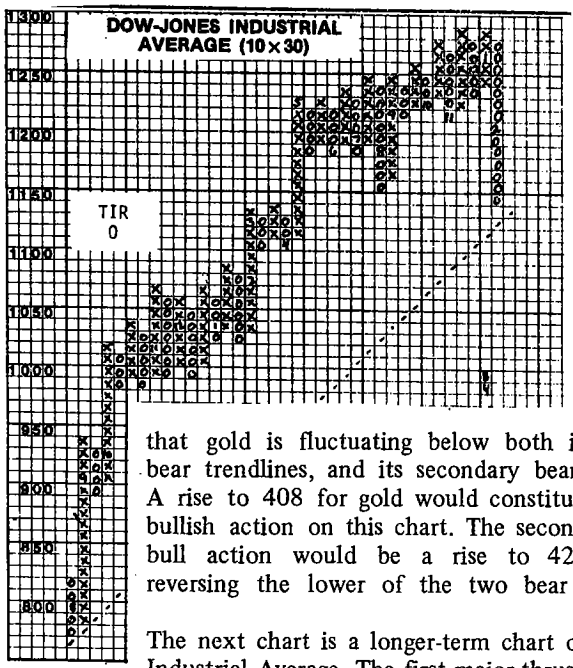
My 13-week rate-of-change index (momentum) has now turned favorable for gold. The momentum index has reversed a 17-month declining trendline. This is a second technical plus for gold.

I am including this long-term chart of gold (courtesy of Dunn & Hargitt). The question can be asked, "was the 1982 low at 295 THE bear market low?" Almost two years have now passed since the extreme low of April 1982–and gold has not violated that low. Two years is a long time for the bear to travel without a new low, so I am beginning to wonder whether that April 1982 low wasn't the bottom for the great bear market in gold.

I have drawn a declining trendline which starts from the February 1983 top. If gold can rise above this trendline, the metal is going to look interesting. Based on my point & figure work and my moving averages, I would say that a rise of gold above 408 would be a signal for initial purchases of the yellow metal (by Canadian Maple Leafs).



Here's an up-dated point & figure chart for gold. I have drawn in the two bearish declining trendlines, and note



that gold is fluctuating below both its primary bear trendlines, and its secondary bear trendline. A rise to 408 for gold would constitute the first bullish action on this chart. The second potential bull action would be a rise to 420, thereby reversing the lower of the two bear trendlines.

The next chart is a longer-term chart of the Dow Industrial Average. The first major thrust of a move often provides hints as to what lies ahead. The recent downside thrust was powerful and persistent. On this chart the downside thrust (the last line of zeros) measures an amazing 140 points. Since this is a three-box reversal chart, on a vertical "count" we multiply the 140 by 3. This gives us 420 potential downside points, measured from the high at 1290. Thus, the projection on the downside (using a vertical count) is 870. That does not mean that the Dow is headed for 870. But it does mean that 870 is not out of the question. A further drop in the Dow to 1120 would violate the rising trendline shown on the chart (both point & figure charts courtesy of Chartcraft, Larchmont, NY).

LATE NOTES: The week ending Feb. 17 saw the PTI waterfall down to 1727. It also saw the three D-J Averages at lows for the entire decline. But perhaps the most important news of the week was the stickiness of the Treasury bond market. The bellwether 12 percent T-Bond of 2013 fell below 100 on Friday, where it yielded 12.01 percent. But even above 12 percent yields were failing to attract investors. ... Meanwhile, gold (reflecting the horrendous U.S. trade deficit) moved over 388. Personally, I feel that gold is reflecting doubts about the dollar rather than fears of inflation (if interest rates run up, such action will be deflationary and reflect a weakening dollar).

NEXT MAILING: March 7